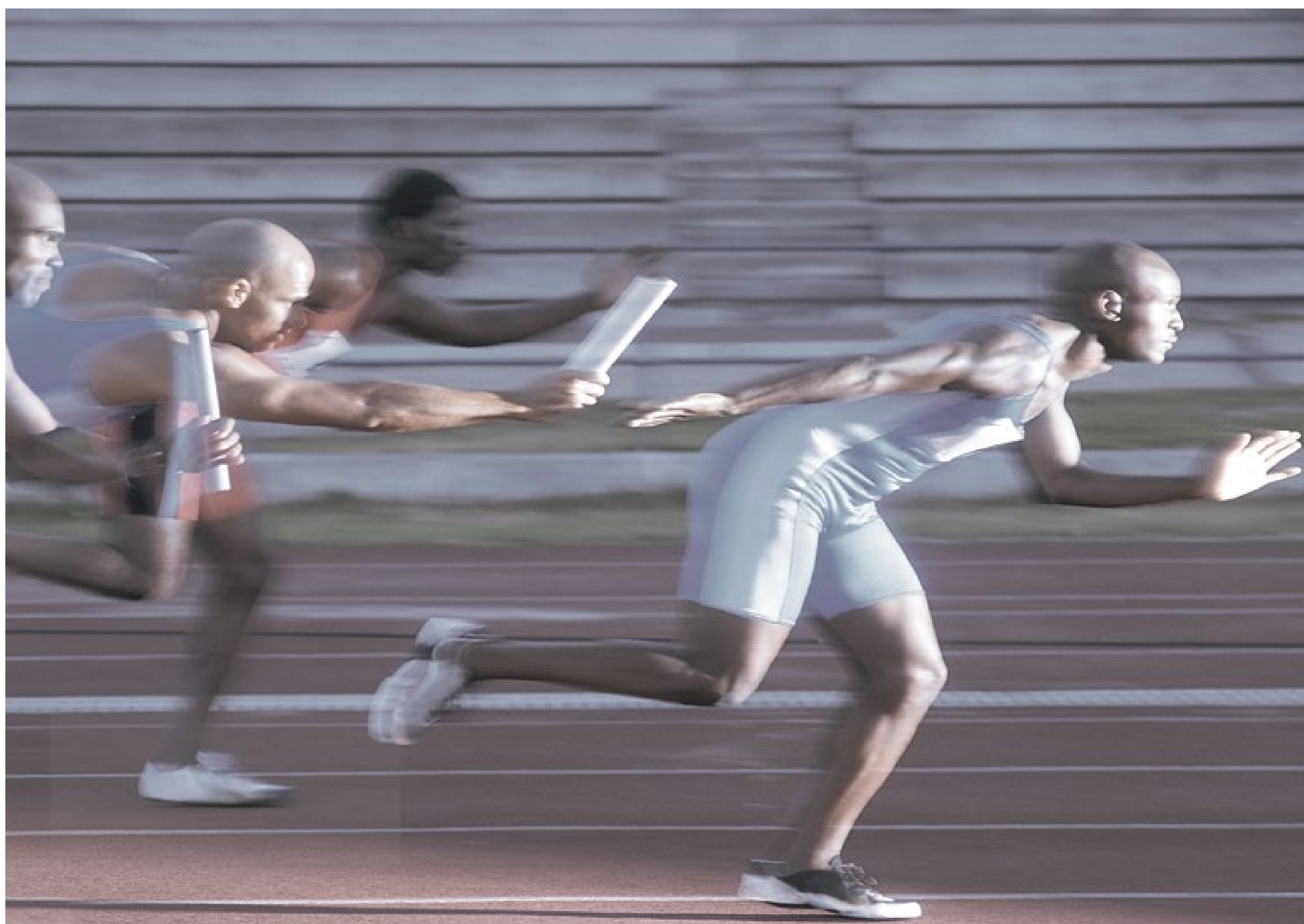
WHITE PAPER | SECURITIES SERVICES

A CLOSER LOOK AT THE IMPLICATIONS OF EMIR AND THE U.S. DODD-FRANK ACT



A CHALLENGE FOR EUROPEAN ASSET MANAGEMENT FIRMS AND THEIR CUSTODIAN BANKS WITHIN A NON STABILISED REGULATORY FRAMEWORK

BUILDING TEAM SPIRIT TOGETHER

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EMIR, ENTERED INTO FORCE ON 16 AUGUST 2012, IS RADICALLY TRANSFORMING THE OTC DERIVATIVES MARKET

However, the regulatory framework is far from stabilised and the technical norms that will enable EMIR to be applied effectively are thus still being discussed. ESMA organised a public hearing on the matter on 12 July 2012, where it was suggested that no clearing obligation is likely to be made applicable before the summer of 2013. The initial objective was to have it applicable from 1 January 2013. Furthermore, talks led by the Basel Committee and IOSCO are currently taking place and will continue through 28 September 2012 where the crucial issue of collateral requirements for non-standard OTC derivatives are being discussed. However, the regulators' caution and concerted action should be applauded.

In terms of volumes, the nominal amount of collateral required should double by 2013, while collateral movements should increase seven-fold.

Doubled collateral requirements and dramatic increase of movements

	Today Limited and flexible requirements	2013 increased and systematic requirements
Worlwide collateral	**USD 3 trio**	**USD 6 trio**
Nature	Mainly mark-to-market (few IA)	Bilateral: MtM + IA / CCP: VM + IM
Reciprocity	Mainly 1-way CSA	Mainly 2-ways
Eligibility/haircuts	Flexible bilateral agreements	CCP/regulators rules
Type of collateral	80% cash, 20% securities	➚ Securities
Frequency	**Weekly**	**Daily**
Number of collateral contacts	170,000 CSA	256,000 CSA
Number of daily movements	**17,000**	**124,000**

Sources: JP Morgan, Tabb Group, City white papers

Major challenges

For asset managers using OTC derivative instruments in their funds, this challenge is now setting up new operational processes, which means choosing clearing brokers, among other things. But they also need to take into account the impact of the new collateral requirements on asset management, and especially the systematic introduction of the 'initial margin' in addition to the already well-known 'variation margin', which is designed to hedge the mark-to-market variation of an OTC derivative instrument. The initial margin is a permanent additional collateral buffer in the form of cash or securities, the value of which is regularly reassessed. This will undoubtedly make life more difficult for asset managers and the optimisation and transformation of a fund's assets liable to be used as collateral will therefore become crucial. Indeed, if a clearing house calls on a fund as collateral, the fund manager has to decide which collateral is the cheapest to deliver. Faced with a possible temporary lack of eligible collateral, cash or securities, the fund manager must also anticipate the transformation strategies which need to be implemented and which will most probably entail the setting up of lending/borrowing operations.

For custodian banks, the challenge is to build suitable high-performance infrastructures capable of supporting a much higher and more complex daily volume. This requires substantial IT investment and robust processes have to be initiated at every stage of the chain.

Substantial changes in operating processes

The new initial response in terms of OTC derivatives will henceforth consist in distinguishing between so- called standard OTC derivatives, which are eligible for clearing, and non-standard OTC derivatives. For the latter, collateral exchanges will continue to take place bilaterally between the two counterparties, although with increased requirements in terms of the amount that must be collateralised ('margin').

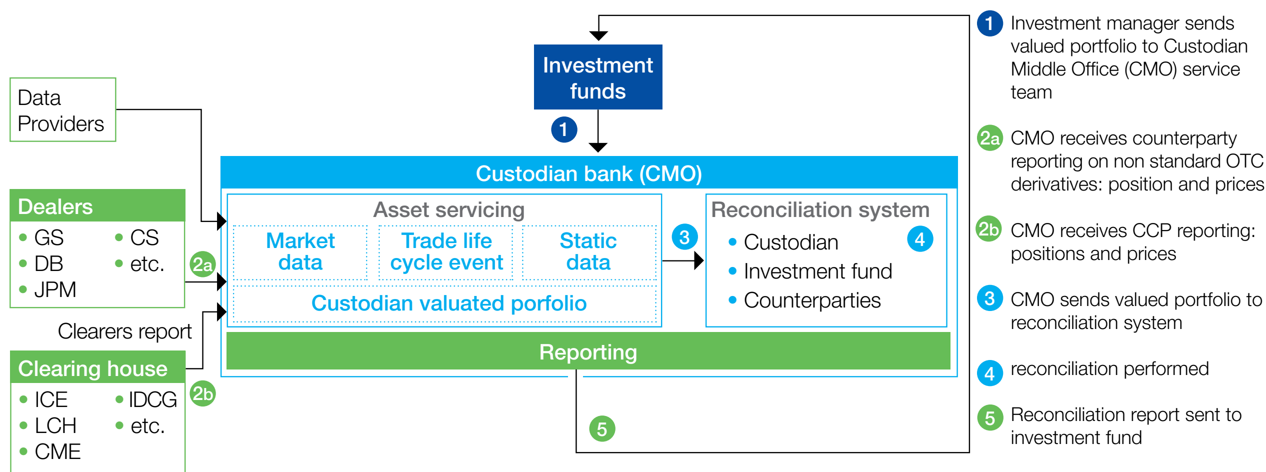
Standard OTC derivatives on the front line in terms of clearing eligibility are interest rate swaps (IRS) and credit default swaps (CDS), which are essential to fixed income portfolio management, whether it be to hedge interest rate and credit risks or to implement alpha-generating strategies.

Previously, there was generally a monthly exchange of collateral for a CDS. From now on, daily collateral exchanges will be required ('variation margins'). Also, asset managers' funds will probably continue to deal with the same counterparties as before for IRS and CDS, with the difference being that most major players, such as Barclays, Goldman Sachs, etc., will now also be clearing agents who

will have to interface with one or more clearing houses. They will have to confirm trades carried out on affirmation platforms. They will then be able to choose between internalising a process and delegating it to their custodian bank. If the case of the latter, they will have to either be logged on these affirmation platforms or be informed by the asset management firms, with the last option probably being the least pertinent. It would then be the responsibility of the custodian bank to execute the payments/receipt of daily requests carried out by the clearing agents employed by the clearing houses.

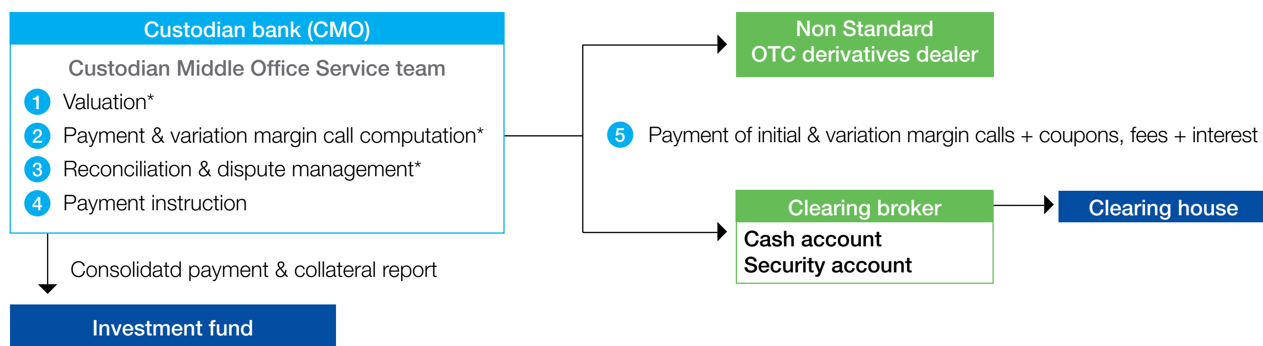
Although easy to describe, the process is only possible with substantial IT investment, which will allow for, in addition to the daily trade flows, a strengthening of the reconciliation and control processes and the production of consolidated reports, which will from now on distinguish between cleared and non-cleared OTC derivative positions. In order to meet the new constraints imposed by EMIR and Dodd-Frank, reconciliation services will now also have to be carried out frequently and will be all the more robust given that they will be based on at least three different sources: the asset managers, the dealers/clearers and an independent agent who provides a position-keeping service and an independent valuation service.

Valuation and reconciliation: target process



The situation will also be more complex in terms of payment and collateral exchanges, because it will now mean carrying out 'netted' exchanges to various players on a daily basis. Furthermore, these will no longer be purely cash exchanges, but could also include securities. The custodian bank will then be responsible for ensuring the transfer of securities in accordance with the eligibility rules of each clearing house and counterparty.

Payments and collateral: target process



** For non standard OTC derivatives*

To the point:

- In Europe, the regulatory framework for OTC derivatives is far from being stabilised, despite the EMIR final vote in May 2012
- The nominal amount of collateral required should double by 2013, whilst collateral movements should increase seven-fold
- The systematic introduction of initial margins in addition to variation margins undoubtedly complicates the task of asset managers and optimising as well as transforming a fund's assets liable to be used as collateral become key questions
- The EMIR and Dodd-Frank reforms are incurring substantial changes in operating processes and for custodian banks; the challenge is to build suitable high-performance infrastructures.

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